# 10. REGULATION

Government regulation of economic activity has a powerful influence. Effective regulations can add to community welfare by preventing undesirable activities, or by requiring problems to be faced by those best placed to solve them.

In the last 10 years, regulations from shop trading hours to ports have been reformed. That has cut costs for some businesses, and encouraged others to innovate and to put their resources to more productive use. At the same time, consumers have benefited from greater choice and lower prices.

A number of regulatory issues now face the Government - or will in the coming months. The most important of these choices relate to the tariff programme, environmental regulation and the regulation of capital markets.

The choices made will have a big effect over time on New Zealand's economic performance and its social outcomes.

## INTRODUCTION

Regulation can be a powerful influence for benefit or harm. Individuals and businesses can undertake their activities in a great variety of ways, and thus can adjust strategically to the regulations they face.

Regulation affects the relative costs of using resources in different activities and the distribution of risks from those activities. Thus government interventions have the potential to enhance the results of these activities greatly, or make them much more difficult and costly than necessary.

Regulation can be particularly beneficial in providing clear legal frameworks and establishing rights and obligations, and in ensuring that the costs and benefits of particular activities - particularly those costs and benefits that fall on third parties - are taken into account, to the extent reasonable.

But regulation also can create unnecessary barriers and costs. Poor regulation can often create protections which enable those costs to be passed on to other people, and can undermine incentives to work, save and invest. The community may be made worse off overall from such regulation, even though particular groups get significant benefits. The costs of regulation may be small initially but grow over time.

## CHOOSING THE BEST POLICY

Governments come under considerable pressure for new regulations. In many cases regulations seem attractive, as they appear to solve problems at little cost to the government. These pressures may be increased over the next few years given the difficult fiscal outlook: when additional government spending is difficult to obtain, interest groups may push harder for regulatory interventions to meet particular concerns.

Governments also face choices between different forms of regulation. The most common form is the command-and-control type which, for example, simply makes illegal the activity in question. But regulation is also involved in many other forms of government intervention. These include amending or creating property rights (the Individual Transferable Quota for fish is an example), subsidy, government provision, or nuisance taxes. The option of doing nothing should also be considered alongside all these options, because it is common for a well-intended regulation to do more harm than good through unintended side effects.

There will never be a perfect solution to many public-policy problems. The challenge for policy-makers is to find the option which contributes most to general welfare. In deciding which option has the greatest net benefits, the following types of questions should be asked:

- What is the problem? Is it a real one deserving of attention in the interests of general welfare, or simply an attempt to obtain support from the rest of the community?

- If there is a genuine problem, which option would be most effective in resolving it? Generally that will be the option that most accurately focuses on the causes of the problem, and which encourages those who can most easily resolve the problem to do so. In particular, is it likely that the Government would have the necessary information to act, and the incentives to operate efficiently?

- Which option has the fewest harmful unintended impacts on the rest of the community?

- Which option would impose least compliance costs on those directly affected? For example, to obtain a building permit an applicant has to lodge an application with the local authority. The applicant may need to attend hearings and hire lawyers to argue a case. These compliance costs will show up both in direct cash payments and through the indirect costs of delays.

- Which option would cost least for all levels of government to operate?

- Which option is most likely to be flexible as economic circumstances and people's preferences change in future, so that it allows the choice and the innovation needed to meet future demands?

### Regulatory Review Mechanism

Regulatory interventions placed before Ministers for approval are generally exposed to far less scrutiny and evaluation than new proposals for public spending. Both should be scrutinised rigorously, since they can impose significant costs on the community. That means that a government should be presented with high-quality, impartial advice on proposed and existing regulations. The analysis should identify the policy option that meets that government's goals at least cost and with the most benefit for the community as a whole.

Effective checks and balances need to be built into the decision-making process. These may involve Select Committees, departmental processes, and independent review bodies which are able to expose the effects of various regulations to public scrutiny.

Developing effective regulatory review mechanisms will not be easy, as the impact of regulatory interventions is often subtle, indirect and dynamic. But it can also be large, and a wide-ranging effort to review and explain the effects of regulation is important.

## INDUSTRY ASSISTANCE AND IMPORT REGULATION

The cutting edge of the emphasis of protection policy has changed. Governments in New Zealand and elsewhere are encouraging the development of globally competitive industries, instead of helping them hide from competition. Much of the reform programme of the last few years has been directed to that end.

A direct government role will continue to be important - for example, in negotiating about the whole gamut of government regulations that affect investment and trade. However this on its own is not a reason for providing direct assistance to particular industries, for example on the grounds that they are in some sense "strategic".

Instead, the development of competitive industries is encouraged by eliminating any costly and unnecessary policy interventions. Similarly, producers in the non-tradables sector should not be supported or protected in ways that impose unnecessary costs on exporters.

The remaining restrictions on imports do not fit with this strategy. The Government restricts imports by means of taxes (tariffs) and, in some cases, quotas (import licensing). These restrictions have had, and continue to have, a profound influence on the economy.

## The Impact of Import Restrictions

For over 50 years governments restricted imports in order to encourage the development of import-substitution industries in New Zealand. But, like many other regulations, import restrictions have had undesirable and often unintended side-effects.

- The benefits of particular import restrictions have been received by relatively small and well organised groups, while their costs have fallen on the wider community and are thus less easily identified.

- Import restrictions promote the industries they protect, but at the same time they suppress others, especially export industries, both through raising the costs of their inputs and through lowering their returns indirectly by tending to put upward pressure on the exchange rate.

- Protection tends to hurt the competitiveness of the whole economy. Protected industries demand more labour and capital than they otherwise would, which increases the costs for other producers. Exporters generally cannot pass on those costs.

- Protection against imports reduces incentives to innovate. Consequently the domestic industry tends to operate with older capital and outmoded production processes.

- Protection also may not promote employment generally. It will keep jobs in the protected sectors, but the development of other industries is inhibited, and they provide fewer employment opportunities as a result.

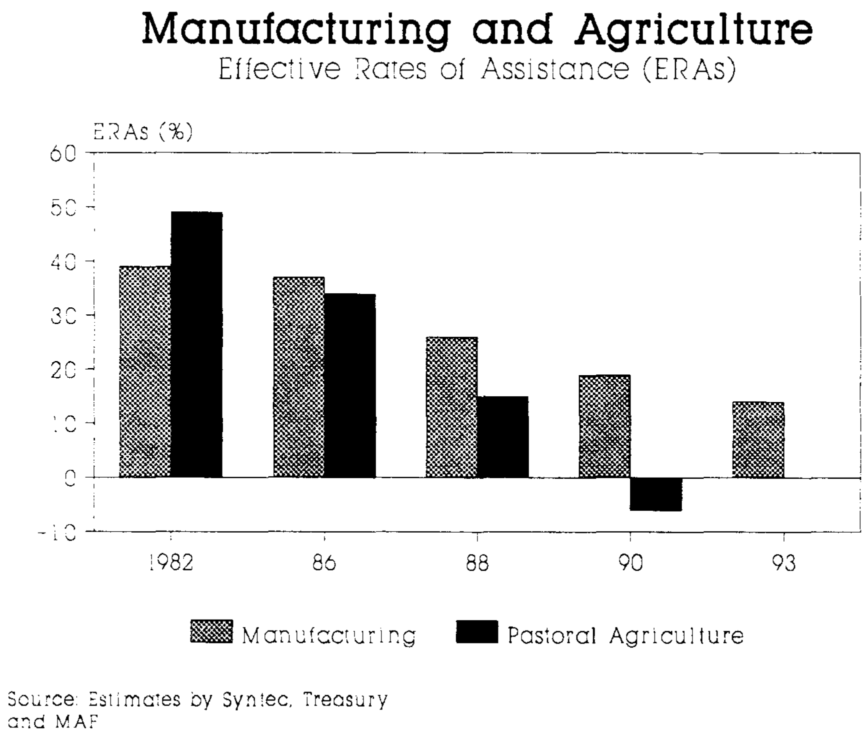
These effects show up in empirical studies which compare economic performance across countries. They show that countries with high levels of protection tend to grow less rapidly.

## Industry Assistance in New Zealand

As these problems have become better recognised, New Zealand governments have reduced import protection. Now, with the full application of CER, quotas and tariffs have been abolished on imports from Australia. For other countries, most import licensing has been abolished and most tariffs have been lowered. As a result of these reforms, the effective rate of assistance for the manufacturing sector has fallen from around 37% in 1985/86 to somewhere around 19% in 1989/90[14]. By 1992, when the current programme of tariff reductions ends, it is expected to fall to something like 14%. All import licensing is to be phased out by 1992.

Despite these reforms, however, large sectors of the economy will continue to remain quite sheltered from international competition. Even after the 1988-92 programme of cuts, some industries will still be protected by very high tariffs: for example, footwear 45%, clothing 40%, cars 35%, and textiles 30%. Many other industries will have tariffs around 17%. Because of these high tariffs, the Government will still be assisting manufacturing at the expense of other sectors. Figure 10.1 compares the assistance (including tariff protection, subsidies, and tax concessions) given to manufacturing with that for pastoral agriculture over the period 1982 to 1993.

*Figure 10.1*

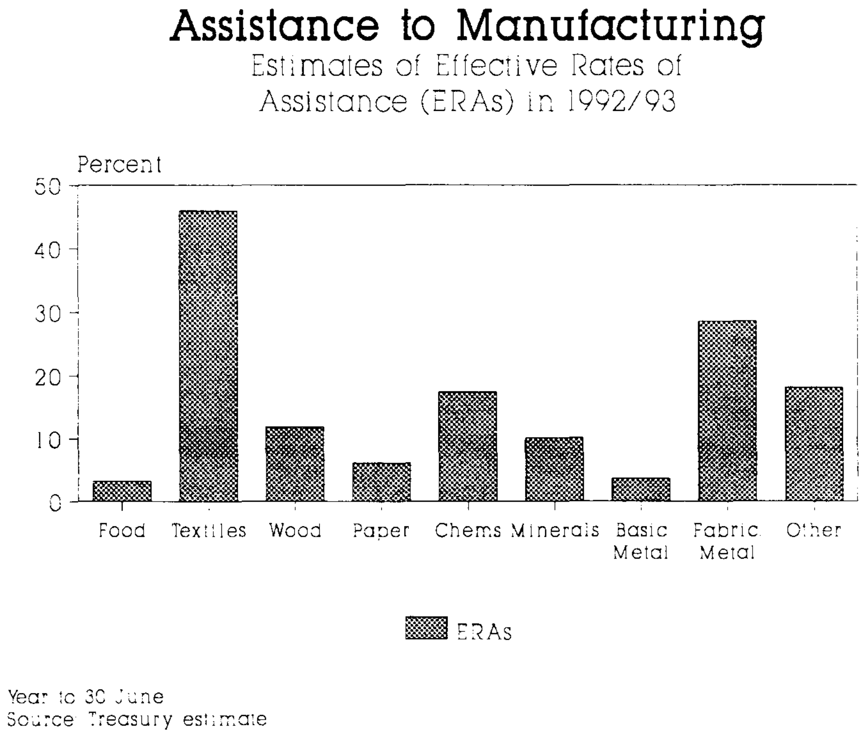



While the assistance given to both industries is falling steadily, pastoral agriculture is now, in effect, being taxed by protection. It is no longer receiving subsidies, but faces higher prices for inputs subject to tariffs.

[14] Effective rates of assistance measure the degree by which an industry's value added is inflated by government assistance.

In addition, different manufacturing industries will continue to receive widely divergent levels of assistance. Figure 10.2 gives an indication of the disparities that may remain within the manufacturing sector in 1992/93.

*Figure 10.2*




Furthermore, tariffs will still bias the economy against exports in 1992. Implementing the post-1992 tariff cuts announced in March this year will help. Those cuts will bring most tariffs down to a maximum of 10% by 1996, thus reducing the assistance given to import substitution at the expense of exporting. They will also reduce further some of the disparities within the manufacturing sector.

The post-1992 programme makes exceptions, however, for three industries: clothing, footwear, and motor vehicles. Tariffs on clothing and footwear will fall to 25% by 1996, while tariffs on motor vehicles will be cut to 30% by 1994. A recent decision was made to change the tariffs on tyres on the same timetable as for motor vehicles. These exceptions mean the major disparities displayed in Figure 10.2 will persist. The textiles and fabricated-metals sectors will continue to receive much higher levels of assistance than others. Significant reductions in those disparities, with the consequent benefits to the wider economy, would require the Government to place clothing, footwear, and motor vehicles on the mainstream track to 10% tariffs by 1996.

## Other Forms of Assistance

In New Zealand, import restrictions have been the most important regulatory instrument used to assist particular industries. But they are not the only instrument. Cheap loans, subsidies for exports or research and development, accelerated-depreciation allowances for capital expenditure, and the like all attempt to boost particular industries.

Although each type of regulation has a different effect, many of the arguments that apply to import restrictions apply equally to others. Crucially, the assistance given to one industry means higher costs for others, and typically leads to a net overall loss for the country. Those costs may be harder to observe than the benefits, which will tend to be obvious, but they are nonetheless real and can be very high.

# ENVIRONMENTAL REGULATION AND RESOURCE MANAGEMENT

General welfare depends not only on having a good material standard of living, but also on the quality of the environment. Often the quality of the environment contributes very directly to the standard of living, for example through improved health.

Achieving environmental quality often requires government interventions. As with other regulation, the more efficient these interventions are, the greater the gains for the community in both environmental and economic terms.

## The Resource Management Bill

The Resource Management Bill, if passed, will be the principal statute governing the use of the environment. It is a major achievement in that it consolidates a large number of resource-use statutes, and simplifies some procedures. It provides for controls on the use of land, air, water, minerals and coastal space.

There are few if any businesses (or indeed households) that will not be affected through the regulation which flows from the Bill. Unwarranted interventions or litigation may occur if local body zoning and other requirements are based on poorly designed regulation. The number of transactions potentially affected is vast, and specific transactions can be very large. There is a major risk of lost or misallocated investment.

### *Relevant Regulatory Objectives and Principles*

The stated objective of the Resource Management Bill is to promote sustainable management of natural and physical resources. As the Bill provides few specific guidelines for local authorities and the Courts, interpretation of the objective could play an important role in guiding their interventions, as has been the case under existing legislation. The objective however, appears to have little relevance to the vast bulk of private transactions the Bill would affect, as these may not involve genuine concern about the sustainable use of natural and physical resources.

In these cases the Bill's objective could cause costly conflicts and unwarranted interventions. Recently a supermarket owner objected to the entry of another competitor on the grounds that establishing a new supermarket was a waste of resources and hence not consistent with the "wise use" of resources: an objective of the present legislation that is used to guide regulatory decisions. If the Bill had been in force, the owner might equally have argued a waste of resources is not consistent with "sustainable management" of resources. The applicability of the Bill's purpose statement to these cases needs review.

In making regulatory decisions, local authorities would be required to consider over 50 vaguely expressed values and aspirations, such as "the enhancement of cultural features that give New Zealand its character" and "the needs of future generations". Again, this raises the prospect of parties seeking to define their objectives in terms of these indeterminate principles. Authorities are likely to make decisions on an arbitrary basis, with little accountability. The risk of costly and ineffective litigation and interventions would be increased further.

The purpose statement and the decision-making criteria should in combination provide a much sharper specification of the environmental, economic and resource management objectives which local authorities are to take into account. In particular, the Bill should be modified to minimise the risk of major displacement of residential, commercial and agricultural investment. This displacement may result from unwarranted interventions such as unnecessary zoning requirements, or excessive scope for objections, due to the Bill's poor specification of decision-making criteria.

### *National Policy Statements*

The Resource Management Bill provides for a range of national policy statements, binding on lower levels of government, to achieve nationally desirable outcomes. The draft Coastal Policy Statement made in anticipation of the Bill passing, proposes among other things a ban on untreated discharges into the sea.

Such statements carry significant fiscal risks for both levels of government, and could encourage inefficiencies. They are regulatory prescriptions which could be made by central government without any careful examination of the costs or who bears them. The result is likely to be tension between the two levels of government over funding, and an associated lack of accountability for the efficiency and cost effectiveness of implementation. The recent commitment by central government to limited sewerage subsidies, and the planned $1 billion spending by local authorities, underline the potential fiscal risks for both levels of government.

Better specification of the objectives and principles in the Bill, combined with willingness to use national quality standards rather than prescribing action, would reduce the need for national policy statements and the risks that accompany them.

### *Pollution Abatement*

The Bill tends to prefer more costly forms of pollution abatement. An example of this is the command-and-control approach it adopts for pollution abatement just as there is a world-wide move away from this to the use of interventions such as transferable permits and emission charges where these are efficient. Because they can provide stronger incentives for those who can reduce pollution to do so, transferable permits and emission charges can often produce better environmental outcomes at a lower economic cost. By failing to encourage their use the Bill may lead to needless loss of both investment and environmental quality.

### General Environmental Policy Issues

Although the Resource Management Bill is the most important environmental policy issue at present, the Government will increasingly come under pressure to protect the environment in other ways. While many proposed interventions appear as little more than common sense, closer examination may reveal they carry very high costs. A current example is the pressure for a refund-deposit system on bottles to help achieve Government's stated target of a 20% reduction in solid waste volumes. It has been estimated that the economic costs of Australia adopting a similar proposal are around $500 million with about $13.85 million in savings from decreased landfill use[15].

Finally, there are environmental policy areas, such as global warming, where our choice of whether to intervene should be guided by international agreement. New Zealand is far too small to affect global warming through its own actions. If the present aim of achieving a 20% reduction in carbon dioxide emissions by the year 2005 is pursued unilaterally, its cost will adversely affect New Zealand's comparative advantage vis-a-vis trading competitors who have not yet taken action, with little effect on the overall world condition.

## CAPITAL MARKETS

Well designed capital-market regulation that allows for the rights and obligations of savers, investors and firms to be clearly defined and enforced can contribute to the achievement of economic growth. Badly designed capital market regulation would add to the costs of investing in New Zealand. Given greater international capital mobility, savers have greater choice where to invest, and firms have greater choice where to raise funds. Thus extra costs in New Zealand because of poor regulation would deter investment in New Zealand.

In recent years there has been a move toward less-restrictive regulations for the New Zealand capital market. Liberalisation has brought about a more efficient financial sector which is now highly competitive. Queuing for loans has disappeared, and borrowers and investors can choose from a large range of financial products and facilities to suit their individual circumstances.

A more diversified financial sector also offers greater security. At one level, a greater number of banks means that the failure of any one bank is less likely to threaten the financial system as a whole. At another level, individual investors can protect themselves more easily by choosing the amount of risk that they want to face. They can diversify their investments more easily and cheaply, including movement into overseas assets.

15 Business Regulation Unit, Australia. Regulations Information Paper 14,1989.

This is linked with radical change in attitudes of New Zealand individual investors, banks and firms, toward a more sophisticated and commercial view of capital markets. This change has not been achieved without cost, given business failures and depressed equity prices. But it does mean that New Zealand capital markets are much more sensitive to investors and are relatively well placed to compete in the future.

## Companies Bill

The Companies Bill introduced into Parliament recently, proposes reform of the law governing the basic structure and rules of companies as well as the law governing takeovers and securities. The objective of this legislation is to set out as simply and clearly as possible the respective rights and obligations of investors and directors, including obligations to third parties such as creditors and employees. The legislation also allows shareholders more freedom to negotiate corporate constitutions that better meet their own circumstances, within the overall framework of the Bill. The draft legislation does vary in some respects from the Law Commission Report on which it is based, and these differences should be carefully reviewed. Priority needs to be given to the development of associated legislation such as the Personal Property Securities Bill.

## Takeovers Legislation

An efficient capital market is needed so that investors and firms can come together to finance investments. Experience suggests that a strong, competitive and vigorous capital market is an important influence on management performance. In particular, share prices indicate to investors and firms the ease or difficulty of raising additional equity and also the possibilities of changing corporate control. The risk of takeover gives an incentive to existing managers to perform in their shareholders' interests. (Other pressures on managers include concern about managerial reputation, and direct monitoring by major or institutional investors).

New Zealand experienced substantial takeover activity prior to the sharemarket fall in 1987. A number of the fast-growing firms (in terms of market capitalisation) have subsequently failed, raising questions about the desirability of greater regulation in these markets. The first point to note is that such failures generally result in the underlying productive assets of such firms being transferred to new owners. While there will be costs in this process, these assets are usually put to sound commercial use. Second, capital markets are concerned with risk-taking which involves taking views about the future. Unexpected events can obviously worsen or improve expected outcomes.

It is less clear whether legislation proposed by the Securities Commission on takeovers can generate net national benefits, given the importance of capital markets and the risk element necessarily involved in the market. The Commission's legislation would require any premium price offered for a controlling interest in a company to be offered to all shareholders. In addition a notice would be required of any intention to make a takeover.

The effect of both of these provisions would be to reduce the incentives to carry out takeovers. The empirical evidence[16] however, is that all shareholders gain from takeovers because they encourage better management of companies. The evidence is generally consistent with the view that takeovers and mergers are a valid and beneficial form of investment for firms - i.e., it may be more economic to buy existing assets rather than invest in more expensive new assets. This proposal is likely therefore to make most investors worse off overall, which is the opposite of its intention.

### Securities Market Regulation

A Ministerial Committee of Inquiry into the Sharemarket was established after the 1987 crash. The Committee's report did not identify the nature of the problem that led to the sharemarket crash, but recommended a comprehensive system of financial-sector regulation based on the guild model (compulsory membership of a trade organisation, self-regulation and control of membership criteria).

The Committee has not explained its reasons for expecting that this form of regulation will improve confidence in the market. Doubts about its effectiveness have been demonstrated by the consequences of the recent major default of a participant in the New Zealand Futures Exchange, which is the first financial "self regulatory organisation" of the form proposed by the Committee.

The doubts are confirmed by the fact that the United Kingdom, which has a similar system of regulation to that recommended by the Committee, was not immune to the sharemarket crash. Beyond that, the Committee's proposals are likely to impose substantial costs. Because the self-regulatory bodies would be able to exclude people from their sector of the industry, the proposals would tend to lead to reduced competition and higher costs. The regime would lead to high compliance costs (in the United Kingdom these are estimated at £1 billion per year), and because those costs can be passed on to clients there would be little incentive to minimise them.

Existing and proposed financial regulations should be carefully tested for their effects on the level of competition, on business costs and flexibility, and on incentives to act prudently. Poorly designed regulations can have major costs. Capital markets are not perfect, but it is clearly an area where there must be great doubt whether heavy-handed regulation will contribute to overall policy goals.

## CONCLUSION

Regulation can be a major contributor to growth and employment. If poorly designed, however, it can reduce or displace much economic activity. The cost of this may not be obvious, because the effects involve subtle changes in a vast array of transactions and identifying them may involve comparisons with "what might have been".

16 See, for example, T. E. Copeland and J. F. Weston, "Financial Theory and Corporate Policy" 1988, Chapter 20.

Regulatory review processes should provide high-quality, impartial advice on regulatory interventions. The community faces considerable costs and risks from current and pending legislation in the areas discussed in this chapter - import regulation, resource management, and capital-market law. Careful analysis of the complex and dynamic impact of regulation should help design and implement these and other interventions in ways which contribute significantly to economic performance.